

Part III - Administrative, Procedural, and Miscellaneous

Taxation of Cross Licensing Arrangements

Notice 2006-34

PURPOSE

This Notice requests information regarding certain transactions commonly referred to as cross licenses in connection with the consideration by the Treasury Department and the Internal Revenue Service (IRS) of requests for specific guidance on the tax treatment of such transactions.

BACKGROUND

A cross license is a contract between two parties that own intellectual property, typically patents, under which each party grants to the other a license with respect to specified property. These rights in the respective patents are often licensed on a nonexclusive and nontransferable basis. One party may make to the other party one or more cash payments representing the difference in value, in the parties' estimation, between the parties' respective rights covered by the cross license. As in one-way patent licenses, other intellectual property related to the exploitation of the patented invention such as know how, trademarks, and copyrights, may also be licensed between the parties.

A company typically will have a number of options available to maximize its

patents' contribution to its profitability, including exploiting its own patents in its own business, one-way licensing, and cross licensing. The Treasury Department and the IRS are aware that cross licenses may arise in a range of commercial contexts. In some cases, each of the parties may intend to exploit the cross licensed patents by making, selling, or otherwise using the patented inventions in its own business. In other cases, the parties may operate their businesses with their own patents, but seek to avoid the risk of patent infringement claims that each might make against the other as a result of the exploitation of their own patents. In between, there may be cases of varying degrees of interdependency on each other's intellectual property in which the parties may seek both to gain access to each other's technology as well as to mutually avoid infringement claims. In this Notice, the Treasury Department and IRS solicit information on the business circumstances in which cross licenses arise, the relative frequency of different circumstances, and trends.

The Treasury Department and the IRS recognize the importance of the rights involved in cross licenses and the significance of the issues raised by these transactions. As a result, the Treasury Department and the IRS believe that cross licenses deserve careful study so that appropriate guidance can be issued on the tax treatment of such transactions.

CHARACTER OF CROSS LICENSING AND TAX CONSEQUENCES

The Treasury Department and the IRS have received requests for guidance on the tax treatment of cross licenses. Among the questions received is whether a U.S. person's grant to a foreign person of the right to use specified intellectual property pursuant to a cross license gives rise to income that may be subject to withholding tax.

In response to these requests for guidance, the Treasury Department and the IRS are analyzing, and expect to issue guidance regarding, certain tax issues related to cross licenses.

The tax treatment of cross licenses depends on the characterization of the cross licensing transactions for tax purposes. Different theories have been suggested by taxpayers and their representatives concerning the proper characterization of cross licensing transactions and the associated tax consequences. To provide a context for the request for information in the next section, a brief summary is provided below of three major theories that have been considered. Other characterizations may also be possible. The description provided below is merely background and is not intended either to be an exhaustive analysis or to be an endorsement of any particular theory or treatment.

The three theories would characterize a cross license as, alternatively, (1) a two-way license of intellectual property rights; (2) a reciprocal agreement not to assert any claims of infringement; or (3) a sale or exchange of property. The Treasury Department and the IRS are considering the most appropriate characterization for cross licensing (e.g., in light of intellectual property law, business realities, or the particular facts of the cross licensing transaction), and the income tax consequences of each theory including the amount, source, and timing of any income, expense, gain or loss from the transaction. The Treasury Department and the IRS are also considering the potential withholding tax consequences if a foreign party is involved.

A. Two-Way License

Under this theory, a cross licensing transaction would be characterized as a two-

way license of intellectual property rights. The potential income tax consequences asserted under this theory could include:

- Gross royalty income is realized by the foreign licensee in an amount equal to the value of the license rights and any cash payments received.
- Income is sourced under sections 861(a)(4) and 862(a)(4).
- Income is recognized currently, except that any contingent payments would be recognized in the period in which they arise.
- The value of license rights conveyed and any cash payments made may be deductible or may be subject to capitalization.
- Withholding tax potentially applies to the conveyance of license rights and any cash payments to a foreign party to the cross license to the extent amounts are allocable to U.S. sources.

B. Reciprocal Agreement Not to Assert Claims of Infringement

Under this theory, a cross license would be characterized as a reciprocal agreement not to assert claims of infringement. A threshold issue would be whether a cross license so characterized is in fact different than a transaction characterized as a two-way license discussed above (or than a sale or exchange of property discussed below). Under this theory, cross licenses might be treated as services or as a covenant not to compete. The potential income tax consequences asserted under this theory could include:

- It has been suggested that the amount of income realized would be limited to the amount of any cash payments. It has also been suggested that the amount of income realized under this theory would be the value of the license

rights and any cash payments received.

- Income would be sourced based on the characterization. For example, if the transaction is analyzed like a traditional two-way license, the income would be sourced under section 861(a)(4) and 862(a)(4). Alternatively, if the transaction is analyzed as services or analogous to services, then the income would be sourced to where the services were performed.
- Income would be recognized currently, except that any contingent payments would be recognized in the period they arise.
- Withholding tax consequences would be based on the U.S. source consequences of a particular characterization. For example, no withholding tax would apply to the extent of services income allocable to foreign sources.

C. Sale or Exchange of Property

Under this theory, a cross license would be characterized as a taxable or nontaxable sale or exchange of property. The potential income tax consequences asserted under this theory could include:

- Gross income is realized in the amount of the gain or loss on the exchange of license rights and any cash payments under the cross license.

Nonrecognition treatment may be available if a nonrecognition provision applies (e.g., section 1031). A determination would be needed on how to allocate basis between the retained rights and the rights transferred in the exchange.

- Gain or loss would generally be sourced based on the residence of the taxpayer, except that any contingent payments would be treated in the same

manner as royalties for sourcing purposes.

- Any gain or loss recognized would be recognized currently, except that any contingent payments would be recognized in the period in which they arise.
- If the transferor is a foreign resident, withholding tax would not apply to gains, except that contingent payments would be sourced in the same manner as royalties and so would potentially be subject to withholding tax to the extent sourced in the United States.

REQUEST FOR COMMENTS, INFORMATION, AND DOCUMENTS

The Treasury Department and the IRS request comments, information, and documents (including samples of cross license agreements as well as of technology transfer policy documents relating to the negotiation of cross licenses) for consideration in providing specific guidance regarding the appropriate tax treatment of cross licenses between U.S. persons and foreign persons. These submissions are critical to providing the Treasury Department and the IRS with the proper information from which to formulate appropriate guidance dealing with cross licensing agreements taking into account practical issues of administrability. In particular, submissions are requested addressing some or all of the following areas:

A. Business Circumstances in Which Cross Licensing Arises

Information is requested on the business circumstances in which cross licenses arise. For example:

1. Mutual Need and Avoiding Claims of Infringement
 - Please explain how companies decide whether or not to engage in licensing or cross licensing of intellectual property. Are there corporate departments or

policies for assessing and valuing transfers of intellectual property? Please describe.

- What are the circumstances in which parties engage in cross licensing out of a mutual need for one another's patents for purposes of operating their own businesses?
- What are the circumstances in which parties have no need for each other's know how, technology, underlying patented inventions, or similar rights, but still seek protection against the risk of infringement claims through entering into a patent cross license? What benefit does entering into a cross license generate in such a case?
- In cases where parties primarily or only seek protection from infringement claims, might parties nevertheless style their agreement as a cross license granting affirmative rights to make, sell, and use technology rather than as a reciprocal covenant not to sue one another for infringement? If so, why?
- Do parties enter into one-way licenses where the licensee has no need for the know how, technology, underlying patented inventions, or similar rights, but still seeks protection against the risk of infringement claims? If so, under what circumstances?
- Do licensors engaged in cross licensing also engage in licensing of the same patent or groups of patents to parties that have little or no significant intellectual property to cross license?
- What are the circumstances in which parties engage in cross licensing where the parties are in different industries or the parties' respective products are

not competing?

- Are there circumstances in which parties would agree that they did not need each other's patents, but nonetheless enter into a cross license? If so, why?
- Are there circumstances in which parties engage in cross licensing in the context of joint product development?
- Are there circumstances where patents are cross licensed on an exclusive (rather than nonexclusive) basis?

2. Industry, Interoperability, and Technical Standards

- In what industries and with what product types are cross licensing agreements most frequently used? How do agreements vary from industry to industry and why?
- What role do industry, interoperability, and technical standards play in cross licensing arrangements? Do parties enter into cross licenses in order to comply with these standards?
- Do such standards ever include, as essential properties, competing patents (or other intellectual property) that constitute independent means for the same or similar business purposes? Please provide examples, if any, of (i) standards that require the use of specific patents, and (ii) standards that may be satisfied, alternatively, via different patents that are designed to achieve a specific function covered by the standard.

3. Intellectual Property Other than Patents

- Do parties to a cross license of patents typically also license additional intellectual property rights such as know how, trademarks, trade secrets, etc.,

associated with exploitation of their patents? What are the circumstances under which such additional rights are, or are not, licensed along with patent rights?

- Apart from patent cross licenses, what other intellectual property rights are typically cross licensed and in what context?
- How should the analysis of patent licenses and cross licenses be similar to, or different from, the analysis of copyright , trademark , and other intellectual property licenses and cross licenses.

B. Distinguishing Among Different Cross Licensing Arrangements

Information is requested on the relevance for tax purposes of potential distinctions between different types of cross licenses and means by which the IRS may in a reliable and administrable manner distinguish between them. For example:

- Is there a basis in intellectual property law for distinguishing different uses of cross licensing arrangements? Does intellectual property law distinguish an agreement not to assert claims of infringement from a license of a patent? Does intellectual property law distinguish between cross licenses based on the necessity of access to each of the parties' intellectual property?
- Are there other grounds on which a "two-way license" can be distinguished from a "reciprocal agreement not to assert claims of infringement"?
- To the extent distinctions in intellectual property and tax law exist, how may the IRS reliably determine that a particular cross license is of one type or another? For example, how may the IRS identify situations in which the parties need one another's patents in conducting their respective businesses

as opposed to situations in which the parties' patents are not used in each other's businesses? Are there typically contemporaneous documents or other circumstances attendant to the execution of a cross license that would support or assist in making any such distinctions?

C. Sourcing the Income from Cross Licensing

Information is requested on the means available to the IRS to determine the source of the income from cross licenses covering intellectual property rights enforceable in more than one country. For example:

- In what respects are the issues different than issues with respect to sourcing the income from a one-way license?

D. Valuation of Cross Licensed Rights

Information is requested on how the parties to a cross license value the licensed rights and determine the amount of any cash payments payable by one party to the other. For example:

- Are there reliable methods for valuing rights transferred under cross licenses?
What economic models do parties (or the consultants they may hire) use to determine the value of the intellectual property exchanged in a cross license?
How do parties determine the amount of any cash payments in a cross license?
- How do parties determine the amount of the royalty in a one-way license of patents?
- Where licensors engage both in cross licensing and one-way licensing of the same patent or group of patents, would the one-way licenses assist the IRS in

valuing the same patent rights reciprocally licensed in a cross license? If not, why not?

- Would the amount of monetary damages that would be sought by a patent holder in a patent infringement suit relating to a particular patent or group of patents assist in valuing the rights transferred in a cross license? If not, why not?
- Where a cross license agreement is entered into following litigation between parties, would the resulting monetary settlement or award help in valuing the rights that are cross licensed going forward? If not, why not?
- Please provide any other information that would assist the IRS in understanding valuation of rights cross licensed.

E. Financial Accounting Treatment of Cross Licensing

Information is requested on the financial accounting and reporting treatment of cross licenses.

F. Foreign Tax Treatment of Cross Licensing

Information is requested on the tax consequences of cross licenses under foreign income tax laws.

SUBMISSION OF COMMENTS

Written comments, information, and documents may be submitted to the Office of Associate Chief Counsel (International), Attention: John E. Hinding (Notice 2006-34), CC:INTL:6, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to notice.comments@irscounsel.treas.gov. Comments will be available for public

inspection and copying. Please include: Notice 2006-34 in the subject line of any electronic communications.

The deadline for submission of comments is May 31, 2006.

DRAFTING INFORMATION

The principal author of this notice is John E. Hinding of the Office of Associate Chief Counsel (International). For further information regarding this notice contact John E. Hinding at 202-435-5156 (not a toll-free call).